

# Steel & Tube Holdings

## 1H20 Result – Softer Demand Adds to the Pain

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### OUTPERFORM

Not surprisingly, there was little new in Steel & Tube's (STU) pre-announced 1H20 result. On the face of it, it does appear that STU's key challenge of late has been soft demand (rather than the self-harm which has been damaging in recent years). Gross margin was flat, and opex (excl. restructuring costs) was down -5%. Management remains perennially optimistic, and expects an improved 2H on the back of contract wins and cost savings (although we acknowledge confidence in such sentiment is difficult given the history of over promise and under delivery). We maintain our high risk OUTPERFORM. In our opinion the market is pricing in a minimal earnings improvement from current suppressed levels. STU is highly levered to any benefits from self-help initiatives or easing in competitive pressures

NZX Code	STU	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$0.82	NPAT* (NZ\$m)	10.0	4.2	11.2	11.7	EV/EBITDA	8.2	4.1	3.2	3.2
Target price	NZ\$0.95	EPS* (NZc)	6.5	2.6	6.9	7.2	EV/EBIT	11.8	10.0	6.2	6.1
Risk rating	High	EPS growth* (%)	-36.6	-59.9	n/a	4.3	PE	12.6	31.4	11.9	11.4
Issued shares	162.5m	DPS (NZc)	5.0	4.0	6.0	6.0	Price / NTA	0.7	0.7	0.7	0.7
Market cap	NZ\$133m	Imputation (%)	100	100	100	100	Cash div yld (%)	6.1	4.9	7.3	7.3
Avg daily turnover	144.7k (NZ\$141k)	*Based on normalised profits					Gross div yld (%)	8.5	6.8	10.2	10.2

### Impacted by softer market demand

STU's pre-announced weak 1H20 (underlying EBIT down -41%) does appear principally due to softer demand which it attributes to declines in the vertical construction and stainless steel markets. Its revenues, down -10% yoy across both its Distribution and Infrastructure divisions, compares to Fletcher Steel's 1H volumes down -16% and EBIT -95%, and NZ Steel's long steel products -8% and flat products -1%.

STU believes it has held market share, headline gross margins have been flat over the past four halves, and operating costs (excluding restructuring costs) were down -5% despite a spike in doubtful debts. Headcount has been reduced from 1,100 to <1,000, and operating sites have dropped from 48 in January 2018 to 31 currently.

No FY20 guidance has been provided. Management remains perennially optimistic, and expects an improved 2H on the back of contract wins and cost savings. Our forecasts are revised for modestly higher opex, EBIT -12%/-8%/-8%, offset at the NPAT line by lower interest. There remains a very high margin of error in any STU earnings forecast.

### Proof in delivery still required for medium-term confidence

We maintain our high-risk OUTPERFORM. With the stock price at a >25-year low, in our view, the stock (understandably) is factoring in minimal improvement from current suppressed levels. We expect the demand backdrop to remain robust. Construction demand is underpinned by tight housing supply, record low interest rates, healthy population growth, and government commitment to transport and social infrastructure. STU's bad debt costs should not reoccur to the same magnitude, and its restructuring initiatives may deliver net cost savings. Competition is negatively impacting all players across the industry and the pendulum of competitive intensity can swing. STU's sensitivity to any operational improvements or easing in competitive intensity is substantial.

**Steel & Tube Holdings Limited (STU)**

Priced as at 24 Feb 2020 (NZ\$)

**0.82**
**12-month target price (NZ\$)\***
**0.95**

Expected share price return	15.9%
Net dividend yield	6.5%
Estimated 12-month return	22.4%

**Spot valuations (NZ\$)**

1. DCF	0.80
2. Sector peer relative	0.97
3. Market relative	0.77

**Key WACC assumptions**

Risk free rate	2.00%
Equity beta	1.50
WACC	9.6%
Terminal growth	1.5%

**DCF valuation summary (NZ\$m)**

Total firm value	258
(Net debt)/cash	(15)
Less: Capitalised operating leases	(113)
Value of equity	130

<b>Profit and Loss Account (NZ\$m)</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>	<b>Valuation Ratios</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
Sales revenue	496.8	499.1	463.8	474.2	484.3	EV/EBITDA (x)	n/a	8.2	4.1	3.2	3.2
<b>Normalised EBITDA</b>	<b>(9.5)</b>	<b>23.6</b>	<b>34.5</b>	<b>41.3</b>	<b>41.8</b>	EV/EBIT (x)	n/a	11.8	10.0	6.2	6.1
Depreciation and amortisation	(8.1)	(7.3)	(20.4)	(19.9)	(19.8)	PE (x)	8.0	12.6	31.4	11.9	11.4
<b>Normalised EBIT</b>	<b>(17.5)</b>	<b>16.3</b>	<b>14.1</b>	<b>21.4</b>	<b>22.1</b>	Price/NTA (x)	0.6	0.7	0.7	0.7	0.7
Net interest	(4.6)	(2.8)	(7.0)	(5.8)	(5.8)	Free cash flow yield (%)	-13.2	5.3	16.2	10.6	11.3
Associate income	0	0	0	0	0	Net dividend yield (%)	8.5	6.1	4.9	7.3	7.3
Tax	8.8	(3.6)	(2.0)	(4.4)	(4.6)	Gross dividend yield (%)	11.2	8.5	6.8	10.2	10.2
Minority interests	0	0	0	0	0						
<b>Normalised NPAT</b>	<b>9.0</b>	<b>10.0</b>	<b>4.2</b>	<b>11.2</b>	<b>11.7</b>	<b>Capital Structure</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
Abnormals/other	(18.7)	0.5	(41.9)	0	0	Interest cover EBIT (x)	n/a	5.8	2.0	3.7	3.8
<b>Reported NPAT</b>	<b>(32.1)</b>	<b>10.4</b>	<b>(36.8)</b>	<b>11.2</b>	<b>11.7</b>	Interest cover EBITDA (x)	n/a	8.4	4.9	7.1	7.2
Normalised EPS (cps)	10.3	6.5	2.6	6.9	7.2	Net debt/ND+E (%)	37.7	5.6	0.2	0.0	0.9
DPS (cps)	7.0	5.0	4.0	6.0	6.0	Net debt/EBITDA (x)	n/a	0.6	0.0	n/a	0.0
<b>Growth Rates</b>	<b>2018A</b>	<b>2019A</b>	<b>2020A</b>	<b>2021A</b>	<b>2022A</b>	<b>Key Ratios</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
Revenue (%)	-3.2	0.5	-7.1	2.2	2.1	Return on assets (%)	-5.1	5.0	3.8	5.7	5.8
EBITDA (%)	n/a	n/a	45.9	19.7	1.3	Return on equity (%)	5.2	3.9	2.1	5.5	5.7
EBIT (%)	n/a	n/a	-13.7	51.7	3.2	Return on funds employed (%)	-4.0	4.1	3.5	6.9	7.0
Normalised NPAT (%)	-54.6	11.2	-57.4	>100	4.3	EBITDA margin (%)	-1.9	4.7	7.4	8.7	8.6
Normalised EPS (%)	-54.6	-36.6	-59.9	>100	4.3	EBIT margin (%)	-3.5	3.3	3.0	4.5	4.6
Ordinary DPS (%)	-56.3	-28.6	-20.0	50.0	0.0	Capex to sales (%)	3.8	1.4	1.5	1.5	1.5
						Capex to depreciation (%)	313	150	41	42	42
<b>Cash Flow (NZ\$m)</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>	Imputation (%)	81	100	100	100	100
<b>EBITDA</b>	<b>(9.5)</b>	<b>23.6</b>	<b>34.5</b>	<b>41.3</b>	<b>41.8</b>	Pay-out ratio (%)	68	77	153	87	83
Working capital change	16.6	(0.2)	9.1	(4.0)	(3.2)						
Interest & tax paid	1.5	(4.9)	(14.8)	(15.9)	(16.1)	<b>Operating Performance</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
Other	(7.3)	(4.4)	0	0	0	<b>Operating revenue</b>	<b>495.8</b>	<b>498.1</b>	<b>462.8</b>	<b>473.2</b>	<b>483.2</b>
<b>Operating cash flow</b>	<b>1.3</b>	<b>14.1</b>	<b>28.8</b>	<b>21.4</b>	<b>22.5</b>	Cost of sales	398.4	387.1	358.7	366.8	374.5
Capital expenditure	(19.0)	(7.0)	(7.1)	(7.3)	(7.4)	<b>Gross margin</b>	<b>97.4</b>	<b>111.0</b>	<b>104.1</b>	<b>106.5</b>	<b>108.7</b>
(Acquisitions)/divestments	52.8	2.3	5.8	0	0	Gross margin %	19.6%	22.3%	22.5%	22.5%	22.5%
Other	0	0	(12.9)	(12.9)	(12.9)						
<b>Funding available/(required)</b>	<b>35.1</b>	<b>9.4</b>	<b>14.5</b>	<b>1.2</b>	<b>2.2</b>	Other revenue	1.0	1.0	1.0	1.0	1.0
Dividends paid	(12.7)	(5.9)	(5.7)	(6.5)	(9.7)						
Equity raised/(returned)	0.0	78.8	0	0	0	<b>Expenses</b>					
<b>(Increase)/decrease in net debt</b>	<b>22.5</b>	<b>82.3</b>	<b>8.8</b>	<b>(5.3)</b>	<b>(7.6)</b>	Operating expenses	107.9	88.3	70.6	66.2	67.9
						Depreciation and amortisation	8.1	7.3	20.4	19.9	19.8
<b>Balance Sheet (NZ\$m)</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>	<b>Total expenses</b>	<b>115.9</b>	<b>95.6</b>	<b>91.0</b>	<b>86.1</b>	<b>87.7</b>
Working capital	165.4	163.6	153.8	157.9	161.2	<b>EBIT</b>	<b>(17.5)</b>	<b>16.3</b>	<b>14.1</b>	<b>21.4</b>	<b>22.1</b>
Fixed assets	52.7	52.0	48.5	50.9	53.2	EBIT margin %	-3.5%	3.3%	3.0%	4.5%	4.6%
Intangibles	57.4	56.9	15.0	12.5	10.3						
Right of use asset	0	0	98.0	98.3	98.5	<b>Expenses % of sales</b>	<b>23.4%</b>	<b>19.2%</b>	<b>19.7%</b>	<b>18.2%</b>	<b>18.1%</b>
Other assets	14.6	3.5	3.5	3.5	3.5						
<b>Total funds employed</b>	<b>290.1</b>	<b>276.1</b>	<b>318.8</b>	<b>323.0</b>	<b>326.7</b>						
Net debt/(cash)	104.4	15.0	0.4	(0.0)	1.8						
Lease liability	0	0	101.8	101.6	101.5						
Other liabilities	13.1	7.2	18.1	18.2	18.2						
Shareholder's funds	172.6	253.9	198.5	203.2	205.2						
Minority interests	0	0	0	0	0						
<b>Total funding sources</b>	<b>290.1</b>	<b>276.1</b>	<b>318.8</b>	<b>323.0</b>	<b>326.7</b>						

\* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

**Figure 1. 1H20 result analysis**

NZ\$m	1H19	1H20	% chg	Forbar	% diff
<b>Revenue</b>	<b>259.0</b>	<b>232.2</b>	<b>-10.3%</b>	<b>232.9</b>	<b>-0.3%</b>
Cost of sales	(200.7)	(180.4)	-10.1%	(181.4)	-0.6%
<b>Gross margin</b>	<b>58.3</b>	<b>51.9</b>	<b>-11.0%</b>	<b>51.5</b>	<b>0.7%</b>
Gross margin %	22.5%	22.3%	-0.8%	22.1%	1.0%
Operating expenses	(45.2)	(42.8)	-5.3%	(46.2)	-7.2%
<b>EBITDA</b>	<b>13.1</b>	<b>9.1</b>	<b>-30.8%</b>	<b>5.4</b>	<b>69.1%</b>
Depreciation & amortisation	(3.7)	(3.6)	-3.2%	0.0	nm
<b>EBIT</b>	<b>9.4</b>	<b>5.5</b>	<b>-41.6%</b>	<b>5.4</b>	<b>2.8%</b>
Abnormal items	0.4	(38.9)	nm	(37.0)	5.1%
<b>EBIT</b>	<b>9.8</b>	<b>(33.4)</b>	<b>nm</b>	<b>(31.6)</b>	<b>5.5%</b>
Interest	(2.0)	(3.5)	78.9%	(4.5)	-22.1%
<b>Net profit before tax</b>	<b>7.9</b>	<b>(36.9)</b>	<b>nm</b>	<b>(36.2)</b>	<b>2.0%</b>
Tax	(2.3)	(0.1)	-96.4%	(0.3)	-74.5%
<b>Net profit after tax</b>	<b>5.6</b>	<b>(37.0)</b>	<b>nm</b>	<b>(36.5)</b>	<b>1.4%</b>
<b>Underlying NPAT</b>	<b>5.2</b>	<b>3.4</b>	<b>-35.6%</b>	<b>0.8</b>	<b>nm</b>
Underlying EPS (cps)	3.7	2.1	-44.8%	0.0	nm
Dividend (cps)	3.5	2.0	-42.9%	1.0	100.0%

Source: Company reports, Forsyth Barr analysis

**Figure 2. Earnings revisions**

NZ\$m	FY20E			FY21E			FY22E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Revenue	463.8	463.8	0.0%	474.2	474.2	0.0%	484.3	484.3	0.0%
EBIT	16.1	14.1	-12.2%	23.3	21.4	-8.3%	24.1	22.1	-8.3%
Adjusted NPAT	5.2	7.2	39.4%	11.6	11.2	-3.4%	12.2	11.7	-3.6%
Adjusted EPS (cps)	3.2	4.5	39.4%	7.2	6.9	-3.4%	7.5	7.2	-3.6%
Dividend (cps)	2.0	4.0	100.0%	5.0	6.0	20.0%	5.0	6.0	20.0%

Source: Forsyth Barr analysis

## Investment Summary

We rate Steel & Tube (STU) as **OUTPERFORM**. With the stock price at a >25-year low, in our view, it is being priced for permanent purgatory. STU's sensitivity to any operational improvements or easing in competitive intensity is substantial. At current levels we view the risk-reward as positive.

### Business quality

- **Intense industry competition:** STU operates in a fragmented and highly competitive industry. For an extended period (pre-FY19) STU shed material market share in its core distribution business principally, in our view, due to customer service deficiencies. This appears to have been checked in FY19, but at a cost to margins. STU's inherently high leverage to inputs (incl. revenue and margins) results in considerable uncertainty over its long-term earnings outlook and valuation.

### Earnings and cashflow outlook

- **Management optimism not yet reflected in the financials:** STU's refreshed board and management have launched a change programme focussed on improved customer service and efficiency. These initiatives underpin ambitious medium-term earnings growth targets (EBIT NZ\$30-35m cf. FY19 NZ\$16m). Difficulty in estimating the potential for turnaround success compounds the inherently high forecasting margin of error for STU. The number and magnitude of profit warnings in recent years emphasises that management's optimism be approached with a high degree of caution.

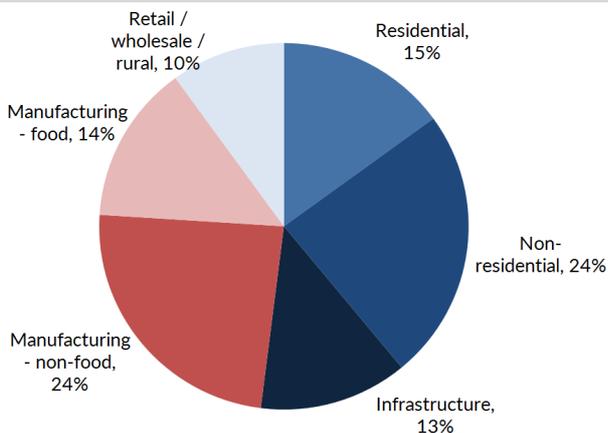
### Financial structure

- **Recapped balance sheet:** Last financial year STU recently recapitalised its balance sheet with an NZ\$81m equity raising. Headline balance sheet metrics have improved significantly to 0.5x FY20E net debt/EBITDA. Underlying gearing remains full given its considerable off balance sheet debt. Capitalising operating leases at 6% FY20E net debt/EBITDA remains at an elevated 7.6x.

### Risk factors

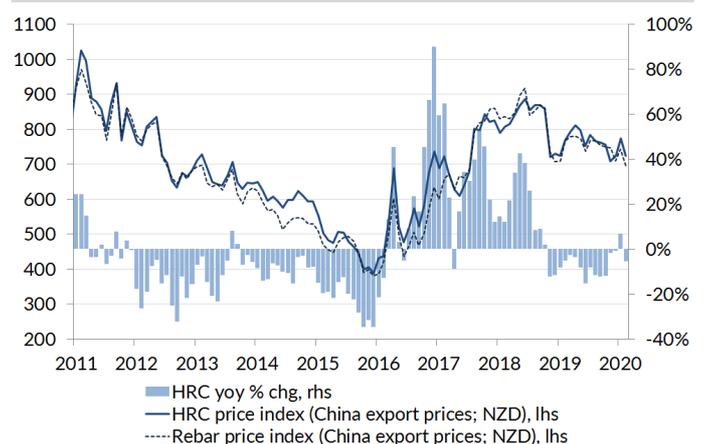
- **Execution of turnaround initiatives.**
- **Competitive pressures on market share and margins.**
- **Domestic steel demand:** Demand for STU's products is impacted by cyclical construction, manufacturing activity, and volatile commodity prices.
- **Steel prices:** Global steel prices are inherently volatile, and can impact short-term margins and the industry profit pool.

**Figure 3. STU sector exposure (1H20)**



Source: Company reports, Forsyth Barr analysis

**Figure 4. Global steel prices**



Source: Bloomberg, Forsyth Barr analysis

**Figure 5. Price performance**


Source: Forsyth Barr analysis

**Figure 6. Substantial shareholders**

Shareholder	Latest Holding
New Zealand Steel Limited	15.8%

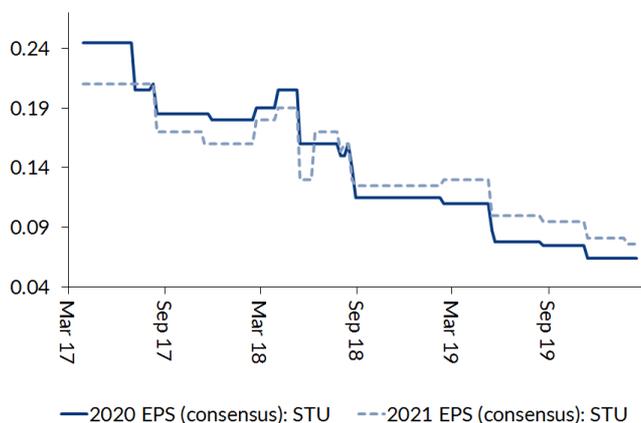
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

**Figure 7. International valuation comparisons**

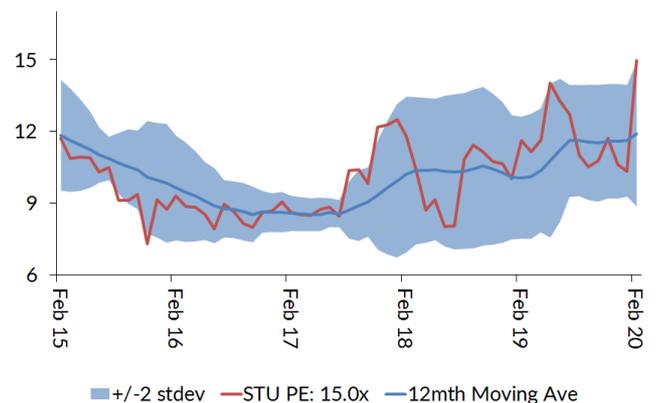
Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld 2021E
				2020E	2021E	2020E	2021E	2020E	2021E	
<b>Steel &amp; Tube Holdings</b>	<b>STU NZ</b>	<b>NZ\$0.82</b>	<b>NZ\$133</b>	<b>31.4x</b>	<b>11.9x</b>	<b>4.3x</b>	<b>3.6x</b>	<b>10.5x</b>	<b>6.9x</b>	<b>7.3%</b>
Fletcher Building *	FBU NZ	NZ\$5.41	NZ\$4,466	16.7x	17.0x	5.4x	5.2x	9.2x	9.4x	4.3%
Metro Performance Glass *	MPG NZ	NZ\$0.27	NZ\$49	4.1x	3.6x	2.9x	3.1x	5.3x	5.3x	15.4%
ADELAIDE BRIGHTON	ABC AT	A\$3.11	A\$2,027	16.8x	16.3x	9.6x	9.5x	14.4x	14.0x	4.2%
BORAL	BLD AT	A\$4.89	A\$5,727	17.9x	15.4x	8.3x	7.7x	16.2x	14.5x	4.3%
BLUESCOPE STEEL	BSL AT	A\$12.62	A\$6,375	15.2x	11.0x	5.2x	4.3x	8.7x	6.4x	1.2%
CSR	CSR AT	A\$4.65	A\$2,285	18.3x	17.0x	8.3x	8.2x	12.3x	12.2x	4.5%
WAGNERS HOLDING CO	WGN AT	A\$1.75	A\$327	25.7x	14.1x	11.3x	8.1x	18.0x	11.4x	3.0%
GWA GROUP	GWA AT	A\$3.70	A\$977	18.7x	17.7x	13.3x	11.9x	14.6x	14.0x	4.8%
JAMES HARDIE INDUSTRIES-CDI	JHX AT	US\$20.10	US\$8,904	23.9x	21.1x	16.0x	14.4x	19.9x	17.6x	2.7%
REECE	REH AT	A\$11.83	A\$6,635	27.3x	24.6x	14.9x	14.0x	19.6x	18.0x	1.9%
SIMS	SGM AT	A\$10.51	A\$2,128	>50x	18.6x	10.6x	6.6x	74.9x	14.0x	2.6%
<b>Compco Average:</b>				<b>18.4x</b>	<b>16.0x</b>	<b>9.6x</b>	<b>8.5x</b>	<b>19.4x</b>	<b>12.4x</b>	<b>4.4%</b>
<b>STU Relative:</b>				<b>70%</b>	<b>-26%</b>	<b>-55%</b>	<b>-58%</b>	<b>-46%</b>	<b>-44%</b>	<b>65%</b>

EV = Current Market Cap + Actual Net Debt

Source: \*Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (STU) companies fiscal year end

**Figure 8. Consensus EPS momentum (NZ\$)**


Source: Forsyth Barr analysis

**Figure 9. One year forward PE (x)**


Source: Forsyth Barr analysis

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